

PERAC AUDIT REPORT



Massachusetts Pension Reserves Investment Management Board



JAN. 1, 2010 - DEC. 31, 2014



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PERAC

COMMONWEALTH OF MASSACHUSETTS | PUBLIC EMPLOYEE RETIREMENT ADMINISTRATION COMMISSION

PHILIP Y. BROWN, ESQ., *Chairman*

JOSEPH E. CONNARTON, *Executive Director*

Auditor SUZANNE M. BUMP | KATHLEEN M. FALLON | KATE FITZPATRICK | JAMES M. MACHADO | ROBERT B. MCCARTHY | JENNIFER F. SULLIVAN

July 27, 2016

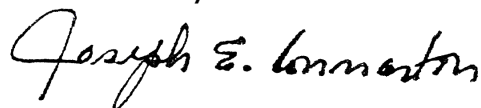
The Public Employee Retirement Administration Commission has completed an examination of the Massachusetts Pension Reserves Investment Management (PRIM) Board, as Trustee of the Massachusetts Pension Reserves Investment Trust (PRIT) Fund, pursuant to G.L. c. 32, § 21. The examination covered the period from July 1, 2010 to June 30, 2014. This audit was conducted in accordance with the accounting and management standards established by the Public Employee Retirement Administration Commission in regulation 840 CMR 25.00. There were certain limitations to the scope of work conducted in accordance with an opinion issued by the Attorney General of the Commonwealth of Massachusetts dated May 29, 2001.

In our opinion, within the limitations to the scope referred to above, the financial records are being maintained and the management functions are being performed in conformity with the standards established by the Public Employee Retirement Administration Commission.

We commend the PRIM Board for its exemplary operation.

In closing, I acknowledge the work of examiners Scott Henderson and Michael Pasternak who conducted this examination, and express appreciation to the PRIM Board, its Executive Director and staff for their courtesy and cooperation.

Sincerely,



Joseph E. Connarton
Executive Director



STATEMENT OF POOLED NET POSITION

(000 Omitted)

AS OF JUNE 30,				
	<u>2014</u>	<u>2013</u>	<u>2012</u>	<u>2011</u>
Assets:				
Investments at fair value				
Short-term	1,152,040	929,693	834,552	854,394
Fixed Income	14,942,944	12,472,026	11,301,393	10,899,750
Equity	25,123,614	22,629,728	19,797,368	23,951,625
Real Estate	6,964,718	5,883,427	4,727,227	4,106,088
Timber	1,510,688	1,368,309	1,197,298	1,029,512
Private equity	6,912,243	6,360,596	6,091,178	5,477,325
Hedge Funds	<u>5,895,470</u>	<u>4,975,666</u>	<u>4,750,032</u>	<u>3,820,815</u>
Total Investments	62,501,717	54,619,445	48,699,048	50,139,509
Cash	189,947	140,375	165,454	76,926
Interest and dividends receivable	142,634	137,178	123,359	126,445
Receivable for investments sold and other assets	791,846	468,780	315,112	149
Securities sold on a when-issued basis	103,776	524,981	360,610	326,022
Unrealized gains on FX currency contracts	<u>7,143</u>	<u>24,351</u>	<u>21,680</u>	<u>8,275</u>
Total Assets	<u>63,737,063</u>	<u>55,915,110</u>	<u>49,685,263</u>	<u>50,677,326</u>
Liabilities:				
Payable for Investments Purchased	\$1,198,048	\$289,983	\$162,739	\$86
Real Estate debt	1,548,854	1,458,221	\$0	\$0
Securities Purchased on a When-Issued Basis	273,711	896,563	\$625,582	\$405,988
Unrealized losses on FX currency contracts	15,084	16,816	7,433	6,141
Management Fees Payable to PRIM	<u>24,592</u>	<u>23,902</u>	<u>21,702</u>	<u>19,345</u>
Total Liabilities	<u>3,060,289</u>	<u>2,685,485</u>	<u>817,456</u>	<u>431,560</u>
Net position held in trust for pool participants	<u>60,676,774</u>	<u>53,229,625</u>	<u>48,867,807</u>	<u>50,245,766</u>

STATEMENT OF CHANGES IN POOLED NET POSITION

(000 Omitted)

FOR THE PERIOD ENDING JUNE 30,				
	<u>2014</u>	<u>2013</u>	<u>2012</u>	<u>2011</u>
Addition:				
Contributions:				
State Employees	\$547,627	\$529,031	\$544,166	\$538,898
State Teachers	709,114	669,815	640,056	616,533
Other Participants	793,507	613,345	898,837	1,535,681
Total contributions	<u>2,050,248</u>	<u>1,812,191</u>	<u>2,083,059</u>	<u>2,691,112</u>
Net Investment Income:				
From Investment Activities:				
Net realized gain on investments and foreign currency transactions	2,948,549	1,728,668	1,184,401	1,696,996
Net change in unrealized appreciation/(depreciation) on investments and foreign currency translations	4,646,758	2,882,344	(2,693,795)	6,262,268
Interest Income	358,677	357,277	342,620	352,183
Dividend Income, Net	699,442	641,126	668,260	624,830
Real Estate Income, Net	241,202	221,963	211,969	202,663
Timber Income (Loss), Net	8,724	(1,843)	(4,730)	139
Private equity Income, Net	<u>172,187</u>	<u>166,768</u>	<u>79,059</u>	<u>99,803</u>
	<u>9,075,539</u>	<u>5,996,303</u>	<u>(212,216)</u>	<u>9,238,882</u>
Management Fees	<u>(84,164)</u>	<u>(73,371)</u>	<u>(68,191)</u>	<u>(69,218)</u>
Total Net Investment Income	<u>8,991,375</u>	<u>5,922,932</u>	<u>(280,407)</u>	<u>9,169,664</u>
Total Additions	<u>11,041,623</u>	<u>7,735,123</u>	<u>1,802,652</u>	<u>11,860,776</u>
Deductions:				
Redemptions:				
State Employees	1,220,075	1,160,706	1,122,208	1,054,196
State Teachers	1,635,224	1,529,320	1,525,530	1,336,545
Other Participants	739,175	683,279	532,873	508,579
Total Deductions:	<u>3,594,474</u>	<u>3,373,305</u>	<u>3,180,611</u>	<u>2,899,320</u>
Net Increase in Pooled Net Position	7,447,149	4,361,818	(1,377,959)	8,961,456
Net position held in trust for pool participants				
Balance, Beginning of Fiscal Year	<u>53,229,625</u>	<u>48,867,807</u>	<u>50,245,766</u>	<u>41,284,310</u>
Balance, End of Fiscal Year	<u>60,676,774</u>	<u>53,229,625</u>	<u>48,867,807</u>	<u>50,245,766</u>

NOTES TO FINANCIAL STATEMENTS

PRIM BOARD OVERVIEW

The Pension Reserves Investment Management (PRIM) Board was created by the state legislature (Chapter 66I of the Acts of 1983). The PRIM Board consists of nine members: the State Treasurer, the State Treasurer's appointee, the Governor (or his designee), the Governor's two appointees, and two representatives each from the State Employees' and Mass Teachers' Systems. The Treasurer serves as its Chair. The Board is charged with the general supervision of the Pension Reserves Investment Trust (PRIT) Fund, which was established by the same act of the legislature and is governed by a declaration of trust adopted by the Board and subject to approval of the legislature.

The PRIT Fund was created with a mandate to accumulate assets through investment earnings and other revenue sources in order to reduce the Commonwealth's unfunded pension liability, and to assist local participating retirement systems in meeting their future pension obligations. The PRIT Fund merged with the Massachusetts State Teachers' and Employees' Retirement System (MASTERS) Trust on January 1, 1997, in accordance with Chapter 315 of the Acts of 1996.

Pursuant to G.L. c. 32, § 23(2A)(e), the Board has authority to employ an Executive Director, outside investment managers, custodians, consultants, and other professionals to formulate policies and procedures and to take other actions necessary and appropriate to manage the assets of the Fund. The Board acts as trustee for each retirement system that invests in the PRIT Fund and is therefore a fiduciary. Accordingly, under G.L. c. 32 § 23 and 840 CMR 1.00, it is required to:

1. Act solely in the interest of the participating retirement systems' members and beneficiaries, for the exclusive purpose of providing benefits and defraying the reasonable costs of managing the systems' assets.
2. Act with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.
3. Diversify the investments of the PRIT Fund in order to minimize the risks of large losses unless under the circumstances it is clearly prudent not to do so.
4. Act in accordance with the PRIT Fund's authorizing statute and governing documents.

NOTES TO FINANCIAL STATEMENTS (Continued)

Pursuant to G.L. c. 32 § 1, fiduciary standards of conduct also apply to PRIM's staff, investment managers, custodians, investment consultants, and others who exercise discretionary authority or discretionary control over the management or disposition of PRIT Fund assets. The Board is responsible for establishing the policies and guidelines by which the PRIT Fund is managed and PRIM is operated. To assist the Board in carrying out its duties, it has established four standing committees as described below. Pursuant to the By-Laws of the Massachusetts PRIM Board, Article II, § 8, the role of each committee is to make recommendations to the Board within its stated area of responsibility. Members of the committees shall be appointed by the chairperson after consultation with other Board members and shall be ratified by Board vote. Such committees may include, at the option of the Board, representatives from PRIM's participating or purchasing systems or from the investment or business community.

Administration and Audit Committee: The Committee reviews all issues related to the administration of PRIM. As such, its responsibilities include but are not limited to: recommending amendments to the PRIT Fund's Operating Trust and the By-Laws of PRIM; authorizing and eliminating staff positions; conducting Executive Director evaluations; overseeing the custodian of the PRIT Fund's assets; the PRIM operating budget and financial statements; staff and Board member travel; and office management. The Committee also oversees the annual audits of the PRIT Fund and PRIM, including the selection and hiring of the auditors, the review of the completed audits, and the PRIM staff's responses to auditors' findings.

Investment Committee: The Investment Committee reviews all investment-related policy, performance, and management issues. The Investment Committee reviews and recommends the broad asset allocation among various asset classes. For all asset classes other than real estate/timber, the committee also reviews and recommends investment structure, recommends hiring and terminating investment managers and consultants, and monitors investment performance.

Real Estate and Timber Committee: The Real Estate and Timber Committee reviews all policy, performance and management issues related to investment in real estate and timber. The Real Estate and Timber Committee reviews and recommends the structure of the real estate and timber asset class, hiring and terminating those investment managers and consultants, and acquiring or disposing of properties where this authority is not delegated to another fiduciary. The committee also monitors investment results and manager performance.

Compensation Committee: The Compensation Committee reviews all issues related to staff compensation and benefit policies.

The Executive Director, with the assistance of PRIM staff, has the responsibility and authority to assist the Board and its committees in establishing investment and administrative policy, to implement the policies and programs established by the Board, and to report to the Board on the status of the PRIT Fund and the operations of PRIM.

NOTES TO FINANCIAL STATEMENTS (Continued)

The Board employs professional investment managers and gives them discretion, consistent with specified objectives and guidelines, to manage the PRIT Fund's assets. The Board and PRIM staff do not directly manage any PRIT Fund portfolios. Each investment manager operates under a formal contract that delineates responsibilities and performance expectations, including formal investment guidelines and administrative requirements for each portfolio. The Board reviews the investment performance of all managers against their stated objectives at least quarterly.

The Board utilizes the services of five investment management consultants to assist the Board and PRIM staff in performance review, asset allocation studies, investment structure analyses, manager screening and selection, investment research and other matters of investment policy, procedures, and implementation. The analysis and recommendations of the consultants may be considered by the Board in conjunction with other available information for the purpose of making decisions.

The Board retains a custodian bank to hold the assets of the PRIT Fund. The custodian accounts for and assists in the settlement of all transactions executed by PRIM's investment managers and makes available to the Board and to PRIM staff information with respect to the holdings, transactions, and performance of the PRIT Fund. Currently, custodial services are provided by BNY Mellon Corp.

The Board may utilize the services of independent auditors, appraisers and other third parties, as needed. Currently, the annual audit is provided by KPMG LLP.

PRIM's mission is to maximize the return on investment within acceptable levels of risk by broadly diversifying the PRIT Fund's investment portfolio, capitalizing on economies of scale to achieve cost-effective operations, and providing access to high quality, innovative investment management firms, all under the management of a professional staff and members of the Board.

PRIT FUND OVERVIEW

The PRIT Fund is a pooled investment vehicle which invests not only the assets of the Teachers' and State Employees' Retirement Systems, but also the assets of various Massachusetts retirement systems that choose to or are mandated to invest in the Fund. The Teachers' and State Employees' Retirement Systems are required by statute to participate. Chapter 68 of the Acts of 2007 required the Public Employee Retirement Administration Commission to assess the investment performance and funded ratio of retirement systems as of January 1st of each year. This law provided that any other public retirement system which underperforms relative to the PRIT Fund by at least 2% on an annualized basis over 10 years and is less than 65% funded must transfer its assets into the PRIT Fund permanently. If any system deemed underperforming had voluntarily transferred its assets into the Fund by October 1, 2007, that system retains the right to revoke its participation after five years.

NOTES TO FINANCIAL STATEMENTS (Continued)

Systems not required to be in the PRIT Fund can invest as either a purchasing or participating system. Participating systems invest all their assets in PRIT and must remain for at least five years; they are entitled to share in appropriations made to PRIT by the Commonwealth in accordance with Massachusetts General Laws, Chapter 32, § 22B. Purchasing systems may invest all or a portion of their assets in PRIT and retain the ability to contribute and withdraw funds at their discretion. These systems are not entitled to share in appropriations made to PRIT by the Commonwealth in accordance with Massachusetts General Laws, Chapter 32, Section 22B. (The Commonwealth has made no such appropriations since fiscal year 2000.) Both the participating and purchasing systems share in the investment earnings of PRIT based on their proportionate share of the net assets of the fund. These systems rely upon the investment strategy of the PRIM Board to maintain their progress toward full funding of the system. That strategy seeks to balance the exposure to common deposit and investment risks related to custody, credit concentrations, interest rate and foreign currency fluctuations.

PRIT consists of two separate investment funds, the Cash Fund and the General Allocation Fund.

The Cash Fund is a short term investment fund that is used to satisfy the liquidity requirements of both participating and purchasing systems. The Cash Fund investments consist of short term liquid cash equivalents. Systems may withdraw funds on the first business day of the month to meet their demands for funding benefit payments and operating expenses. Investment earnings consist primarily of interest and are reinvested daily.

The General Allocation Fund invests in all the asset classes of PRIT in accordance with the current asset allocation strategy. This portfolio spans a widely diversified investment spectrum. Each participating and purchasing system shares in the investment results of this portfolio in proportion to its contribution. Redemptions are permitted based on established guidelines at specific intervals usually at every month end.

Purchasing systems are allowed to specify their contributions to certain segments of the PRIT investment spectrum. This option was provided as an alternative to investing in the General Allocation Fund. The investment risk assumed is commensurate with the ordinary exposure inherent to the particular segment they participate and invest in.

On May 29, 2001, the Attorney General of the Commonwealth of Massachusetts issued an opinion stating “that PERAC lacks authority to review the process adopted by the PRIM Board for the selection of particular investment managers or advisors, or to assess the results of such selections.” The Attorney General’s decision was the result of a request in November 2000 by PERAC to clarify its authority with respect to PRIM’s selection process for its investments and investment managers. In light of the Attorney General’s decision, the scope of this PERAC audit is limited in reviewing the investment practices of the Board.

PERAC

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